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PASS CEA, TREASURY, FRB

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SUBJECT: ECONOMIC AND DEVELOPMENT REVIEW COMMITTEE (EDRC)
REVIEW OF THE U.K., JANUARY 29, 1976

REFS: (A) EDR(76)3, (B) STATE 21503

1. SUMMARY: EDRC REVIEW OF U.K. BROUGHT OUT ONLY MINOR DIFFERENCES BETWEEN U.K. AND SECRETARIAT ON PROSPECTIVE EVOLUTION IN 1976 OF DOMESTIC DEMAND COMPONENTS. WHILE U.K. WAS SLIGHTLY MORE OPTIMISTIC THAN SECRETARIAT, U.K. DELEGATION (LED BY DOWNEY, HMT) MINIMIZED SIGNIFICANCE OF DIFFERENCES AND STATED THAT U.K. WAS REVISING ITS ESTIMATES IN CONJUNCTION WITH 1976-77 BUDGET. MOST SIGNIFICANT GAP BETWEEN U.K. AND SECRETARIAT FORECASTS CONCERNED GROWTH OF 1976 MERCHANDISE EXPORT VOLUMES, WITH U.K. FORECASTING GROWTH OF 8 PERCENT COMPARED WITH SECRETARIAT ESTIMATE OF 1.75 PERCENT. DIFFERENCE PARTLY
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ATTRIBUTABLE TO SECRETARIAT'S ASSUMING CONSTANT EFFEC-

TIVE STERLING EXCHANGE RATE IN 1976, WHILE U.K. STATED POLICY OF MAINTAINING "CONSTANT COMPETITIVENESS" (EUPHEMISM WITH IMPLICATION THAT STERLING WILL BE ALLOWED TO DEPRECIATE DURING THE YEAR TO EXTENT THAT U.K. INFLATION RATE EXCEEDS THAT OF ITS COMPETITORS). U.K. AGREED WITH EDRC THAT PRIMARY POLICY GOALS FOR 1976 SHOULD BE REDUCTION IN INFLATION AND IN CURRENT ACCOUNT DEFICIT, AND THAT TO THESE ENDS EFFECTIVE POST-AUGUST, 1976, INCOMES POLICY WOULD BE CRUCIAL. U.K. HAS NOT YET DECIDED ON FORM OF POST-AUGUST PAY LIMITS (FLAT RATE, PERCENTAGE OR COMBINATION), BUT FELT THAT TARGET FOR OVERALL WAGE INCREASES WAS CENTRAL ISSUE, U.K. OBJECTIVE IS TO ACHIEVE WAGE INCREASES CONSISTENT WITH BRINGING INFLATION RATE DOWN TO THAT OF U.K. COMPETITORS. TO COMPLEMENT WAGE POLICY, U.K. PLANS TO CONTINUE MODERATELY RESTRICTIVE FISCAL POLICY IN 1976 AND TO SEEK TO LIMIT GROWTH OF MONEY SUPPLY TO PROJECTED GROWTH OF NOMINAL GNP. U.K. ISOLATED DECLINING TREND IN INVESTMENT AND INCREASING SHARE OF PUBLIC SECTOR AS IMPORTANT MEDIUM-TERM PROBLEMS, AND NOTED THAT HMG WOULD RELY HEAVILY ON "NEW INDUSTRIAL STRATEGY" TO REVERSE INVESTMENT DECLINE. CONCERNING SHARE OF PUBLIC SECTOR, U.K. DEL STATED THAT HMG WILL SOON IMPLEMENT PROGRAM TO IMPROVE CONTROL OF PUBLIC SPENDING TOWARD MEDIUM-TERM OBJECTIVE OF REDUCING RELATIVE SHARE OF PUBLIC SECTOR IN GNP.

2. EDRC CONCLUDED THAT U.K. HAD MADE SUBSTANTIAL PROGRESS IN PUTTING ECONOMIC HOUSE IN ORDER IN 1975, BUT CITED SIGNIFICANT RISKS INHERENT IN LATENT POTENTIAL FOR ACCELERATED WAGE/PRICE INFLATION, AND STRESSED THAT RELAXATION OF POLICY STANCE COULD LEAD TO RAPID EROSION OF HARD-FOUGHT GAINS. EDRC ALSO EMPHASIZED THAT DEMAND MANAGEMENT POLICIES SHOULD BE FORMULATED WITH MEDIUM-TERM GOALS (INCREASING PRIVATE INVESTMENT AND PROFITS, CONTROLLING PUBLIC EXPENDITURE) IN MIND TO HELP ASSURE THAT RECOVERY WILL BE SUSTAINABLE, AND JOINED IN U.K. DEL'S EXPRESSION OF "CAUTIOUS OPTIMISM" CONCERNING HMG'S ABILITY TO IMPLEMENT APPROPRIATE AND EFFECTIVE POLICIES. END SUMMARY

3. SHORT-TERM PROSPECTS; DOMESTIC DEMAND: WHILE INDICATED LIMITED OFFICIAL USE

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CATING OFFICIAL FORECASTS CURRENTLY BEING REVISED FOR NEW BUDGET, U.K. DEL EXPRESSED SOMEWHAT MORE OPTIMISM THAN SECRETARIAT CONCERNING 1976 PROSPECTS FOR PRIVATE DOMESTIC DEMAND COMPONENTS, OUTLINING TENTATIVE EXPECTATION OF 3 PERCENT DECLINE IN FIXED INVESTMENT, 1.5 PERCENT FALL IN PRIVATE CONSUMPTION, JUST OVER 1.25 PERCENT CONTRIBUTION TO 1976 GDP FROM STOCK MOVEMENTS, AND 2-2.5 PERCENT INCREASE IN REAL GDP. SECRETARIAT

SEES NO GROWTH IN REAL GDP, 4.25 PERCENT DROP IN FIXED
INVESTMENT, 1.25 PERCENT STOCK CONTRIBUTION, AND 1.5
PERCENT FALL IN REAL PRIVATE CONSUMPTION.

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4. U.K. PROJECTS SOMEWHAT GREATER ACCELERATION IN
INVESTMENT IN SECOND HALF OF 1976 THAN DOES SECRETARIAT,
AND CITES INVESTMENT SUBSIDY SCHEME AS MAJOR REASON.
(SCHEME IS DESIGNED TO SHIFT INVESTMENT SPENDING PLANNED
FOR 1977 BACK TO 1976. U.K. ESTIMATES THAT FOR EVERY
1 POUND IN SUBSIDY, 6 POUNDS OF INVESTMENT WOULD BE
ADVANCED; TOTAL SPENDING ON SCHEME IS 120,000 POUNDS.)
MOREOVER, U.K. DOES NOT EXPECT FINANCING TO BE CONSTRAINT
ON INVESTMENT FOR FOLLOWING REASONS: (A) CYCLICAL UPTURN
IN PRODUCTIVITY AND CAPACITY UTILIZATION WILL IMPROVE

PROFITS; (B) LAST YEAR'S DECISION TO ALLOW TAX DEDUCTION

FOR INVENTORY APPRECIATION WILL IMPROVE NET PROFITS
(HMG IS STILL DISCUSSING TECHNICAL ASPECTS OF INFLATION
ACCOUNTING RECOMMENDATIONS CONTAINED IN SANDILANDS
REPORT, BUT HAS ACCEPTED RECOMMENDATIONS IN PRINCIPLE);
(C) DECELERATION OF INFLATION WILL IMPROVE REAL PROFITS;
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(D) TAX DEFERRAL ON NEW INVESTMENTS WILL BOLSTER CORPOR-
ATE LIQUIDITY. NEVERTHELESS, U.K. DEL MINIMIZED
IMPORTANCE OF U.K./SECRETARIAT DIFFERENCES ON DOMESTIC
DEMAND, AND NOTED THAT FORECAST OF EITHER SIDE WOULD BE
ENCOMPASSED IN OTHER'S RANGE OF ERROR.

5. WAGES AND PRICES: U.K. JOINED IN EDRC CONSENSUS
THAT 6-POUND LIMIT WAS MAJOR REASON FOR DECELERATION OF
INFLATION IN 1975 AND THAT CONTINUED WAGE RESTRAINT IN
POST-AUGUST 1976 (PHASE II) PERIOD WOULD BE CRUCIAL TO
U.K.'S TWIN POLICY GOALS OF REDUCING INFLATION AND
CURRENT ACCOUNT DEFICIT. SECRETARIAT AND SEVERAL DELS
STRESSED THAT ANOMALIES HAD BEEN CREATED BY COMPRESSION
OF WAGE DIFFERENTIALS UNDER 6-POUND LIMIT, AND QUESTIONED
U.K. RE (A) WHAT FORM PHASE II INCREASES SHOULD TAKE TO
CORRECT ANOMALIES, AND (B) HOW STRONG INFLATIONARY
PRESSURE (ARISING FROM ATTEMPTS TO REESTABLISH ORIGINAL
WAGE DIFFERENTIALS) WOULD BE WITH TERMINATION OF INCOMES
POLICY (THE "REENTRY PROBLEM"). U.K. STATED THAT FORM
OF PHASE II WAGE INCREASE SHOULD RECOGNIZE THAT FLAT
POUND LIMIT HAD PRODUCED SOME ANOMALIES, AND AGREED THAT
SECRETARIAT'S RECOMMENDATION FOR PHASE II OF COMBINATION
OF FLAT RATE AND PERCENTAGE INCREASES WOULD HELP RE-
ESTABLISH WAGE DIFFERENTIALS IN CONTROLLED MANNER, AND
WOULD MINIMIZE REENTRY PROBLEMS. U.K. ADDED THAT LARGE
UNIONS WERE SPLIT ON QUESTION OF FLAT RATES VS. PER-
CENTAGE INCREASES (DEPENDING ON AVERAGE PAY OF THEIR
MEMBERS), BUT EMPHASIZED THAT UNION DEBATE WAS PRIMARILY
OVER FORM OF WAGE LIMITS - NOT WHETHER OR NOT LIMITS
SHOULD BE IMPOSED. EDRC AND U.K. CONSIDERED THIS A
MAJOR STEP FORWARD. U.K. DEL ADDED THAT CONTINUATION
OF WAGE LIMITS AFTER AUGUST, 1976 WAS OF OVERRIDING
IMPORTANCE AND THAT HMG, IN SETTING FORM OF LIMITS,
WOULD ACCEPT OUTCOME OF UNION DEBATE DESPITE FACT THAT
FLAT RATE INCREASE WOULD FURTHER COMPRESS WAGE DIFFEREN-
TIALS. U.S. NOTED THAT SCOPE FOR RISE IN REAL INCOMES
WAS LIMITED, THAT GIVEN CHANGES IN REAL INCOMES SHOULD
BE ACHIEVED AT LOWER RATHER THAN HIGHER RATES OF INCREASE
IN NOMINAL WAGES AND PRICES, AND THAT THEREFORE TARGET
FOR PHASE II LIMIT WAS AS IMPORTANT AS MIX. U.K.
AGREED, AND STATED THAT AIM WOULD BE FURTHER DECELERA-
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TION IN WAGE INCREASES SO AS TO REDUCE INFLATION RATE
TO THAT OF U.K.'S MAIN COMPETITORS.

6. EMPLOYMENT: U.K. EXPECTS UNEMPLOYMENT TO CONTINUE
UPWARD IN 1976, BUT AT LOWER RATE THAN FORESEEN BY
SECRETARIAT. U.K. STATED INTENTION TO RESIST PRESSURES
(ENGENDERED BY RECENT RISE IN UNEMPLOYMENT RATE ABOVE
6 PERCENT) TO STIMULATE AGGREGATE DEMAND, AND INSTEAD
WILL RELY ON EXTENSION OF SELECTIVE, COST-EFFECTIVE
MEASURES (EMPLOYMENT CREATION AND RETENTION SUBSIDIES)
OF TYPE IMPLEMENTED IN AUTUMN OF 1975. IN ADDITION, U.K.
NOTED THAT EXTENSION OF THESE MEASURES WOULD BE CAUTIOUS
LEST SUM TOTAL OF "SELECTIVE" STIMULI BECOME EQUIVALENT
IN ECONOMIC IMPACT TO EXPANSION OF AGGREGATE DEMAND.

7. CURRENT ACCOUNT: MAJOR DIFFERENCE BETWEEN U.K. AND
SECRETARIAT FORECASTS CONCERNED GROWTH OF 1976 MERCHAN-
DISE EXPORT VOLUMES, WITH U.K. FORECASTING GROWTH OF
8 PERCENT (6.5 PERCENT GROWTH OF GOODS AND SERVICE
EXPORTS), COMPARED WITH SECRETARIAT PROJECTION OF ONLY
1.25 PERCENT MERCHANDISE EXPORT RISE, ALTHOUGH U.K. PRO-
JECTS MORE GROWTH IN ITS MARKETS THAN DOES SECRETARIAT
(7 PERCENT VS. 3.5 PERCENT), DIFFERENCE ALSO RESULTS
FROM SECRETARIAT'S ASSUMPTION CONCERNING U.K. EXCHANGE
RATE POLICY IN 1976. SECRETARIAT ASSUMED EFFECTIVE STERL-
ING RATE WOULD REMAIN UNCHANGED DURING YEAR, WHILE U.K.

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STATED THAT ITS POLICY WOULD BE TO MAINTAIN "CONSTANT COMPETITIVENESS," WITH STERLING DEPRECIATING TO EXTENT THAT 1976 U.K. INFLATION RATE EXCEEDS THAT OF ITS COMPETITORS. (TAKING SECRETARIAT PROJECTION OF 8 PERCENT INFLATION RATE FOR OECD AS A WHOLE AND OF 15 PERCENT FOR U.K., THIS WOULD IMPLY, ON CRUDE, UNWEIGHTED BASIS, THAT STERLING COULD DEPRECIATE AS MUCH AS 7 PERCENT DURING YEAR.) U.K. ADDED THAT STERLING DEPRECIATION SINCE 1973 HAD MORE THAN OFFSET EFFECT OF DOMESTIC INFLATION.

8. U.K. ALSO PROJECTS HIGHER GROWTH IN REAL IMPORTS THAN DOES SECRETARIAT (3.5 PERCENT VS. 2.5 PERCENT), AND FEELS THAT SECRETARIAT ESTIMATE OF \$4 BILLION CURRENT ACCOUNT DEFICIT FOR 1976 PROBABLY CLOSE TO MARK.

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9. DESPITE LARGE PROJECTED CURRENT ACCOUNT DEFICIT, NEITHER U.K. NOR SECRETARIAT FORESEES FINANCING PROBLEMS FOR THIS YEAR. FINANCING PROBLEM COULD ARISE OVER MEDIUM TERM, HOWEVER, AND IN LETTER TO IMF, U.K. STATED INTENTION TO BRING CURRENT ACCOUNT INTO BALANCE BY 1978. U.K. EXPECTS NORTH SEA OIL REVENUES TO PLAY IMPORTANT ROLE IN ACHIEVING GOAL OF BALANCE, AND CURRENT OFFICIAL ESTIMATES INDICATE THAT NORTH SEA OIL PRODUCTION WILL HAVE NET POSITIVE BALANCE-OF-PAYMENTS IMPACT OF 2.5 BILLION POUNDS IN 1978. U.K. NOTED THAT REVISED ESTIMATES OF NORTH SEA OIL PRODUCTION AND REVENUES WOULD BE READY IN 2-3 WEEKS, BUT THAT EVEN REVISIONS SUBJECT TO GREAT UNCERTAINTY (WITH THEIR EXTREME SENSITIVITY TO ASSUMED COURSE OF OIL PRICE, ETC.). U.K. DEL DID NOT COMMENT ON SECRETARIAT ASSESSMENT THAT NORTH SEA REVENUES WILL NOT BE SUFFICIENT IN THEMSELVES TO ALLE-

VIATE EXTERNAL DEBT SERVICE BURDEN OVER MEDIUM TERM.

10. FISCAL AND MONETARY POLICY: U.K. PLANS TO MAINTAIN MODERATELY RESTRICTIVE FISCAL POLICY IN 1976 TO LIMIT INCREASES IN PUBLIC AND PRIVATE CONSUMPTION AND THUS TO HELP ASSURE THAT RECOVERY IS LEAD BY INVESTMENT AND EXPORTS. U.K. DEL FELT CONSTRAINED NOT TO DISCUSS DETAILS OF 1976-7 BUDGET BEFORE PRESENTING IT TO PARLIAMENT IN MID-FEBRUARY, AND WAS STILL NOT SURE OF EXTENT TO WHICH EXPENDITURES UNDER 1975-76 BUDGET WOULD EXCEED LEVELS PLANNED IN MARCH, 1975. (THEY WERE THUS UNABLE TO SHED MUCH LIGHT ON SPECIFIC POINT RAISED PARA 4 REF B.) U.K. ALSO COMMENTED THAT SIZE OF PUBLIC SECTOR BORROWING REQUIREMENT (PSBR) DIFFICULT TO ESTIMATE (1 PERCENT CHANGE IN SPENDING OR RECEIPTS PRODUCES HALF-BILLION POUND CHANGE IN PSBR; CHANCELLOR'S LETTER TO IMF CONTAINS PSBR LIMIT OF 12 BILLION POUNDS), BUT STATED THAT DEBT MANAGEMENT MEASURES WOULD BE TAKEN AS NECESSARY TO STRIKE BALANCE BETWEEN EXCESSIVE LIQUIDITY CREATION AND "CROWDING OUT."

11. MONETARY POLICY WILL ALSO REMAIN MODERATELY RESTRICTIVE IN 1976. ALTHOUGH U.K. DOES NOT INTEND TO SET SPECIFIC TARGETS FOR GROWTH OF MONEY SUPPLY, OBJECTIVE IS MONETARY EXPANSION EQUAL TO PROJECTED GROWTH OF LIMITED OFFICIAL USE

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NOMINAL GDP. POLICY AIMS ARE TO LUBRICATE EXPANSION AND TO ADJUST SHORT-TERM INTEREST RATES SO AS TO PREVENT CAPITAL OUTFLOWS AND DOWNWARD PRESSURE ON STERLING.

12. MEDIUM-TERM PROBLEMS: U.K. JOINED IN EDRC VIEW THAT MEDIUM-TERM POLICY SHOULD BE DIRECTED AT REVERSING

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DECLINE IN PRIVATE INVESTMENT AND REDUCING SHARE OF PUBLIC SECTOR IN GDP. TO TACKLE INVESTMENT PROBLEM, U.K. WILL RELY ON "NEW INDUSTRIAL STRATEGY," WHICH U.K. DEL DESCRIBED AS "ROLLING PROGRAM" DESIGNED TO OVERHAUL INDUSTRIAL STRUCTURE TO INCREASE MEDIUM-TERM OUTPUT AND EMPLOYMENT POTENTIAL. U.K. HAS NO PRECISE TIMETABLE FOR IMPLEMENTATION, BUT SAID THAT DETAILED STUDIES OF 30 SECTORS DESIGNATED FOR PRIMARY CONSIDERATION SHOULD BE COMPLETED BY JUNE, 1976, AT WHICH TIME FORMULATION AND IMPLEMENTATION OF PLANNING AGREEMENTS WOULD BEGIN. PLANNING AGREEMENTS WILL BE ESTABLISHED IN TRIPARTITE NEGOTIATIONS (GOVERNMENT, INDUSTRY AND LABOR), AND U.K. SUGGESTED THAT SUCH NEGOTIATIONS COULD CONSTITUTE EFFECTIVE FRAMEWORK FOR WAGE BARGAINING AND VIABLE SUCCESSOR TO FORMAL INCOMES POLICY (WHICH U.K. HOPES TO TERMINATE AT END OF PHASE II).

13. REDUCTION IN SHARE OF PUBLIC SECTOR IN GDP SEEN BY LIMITED OFFICIAL USE

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U.K. AS ESSENTIAL TO MAKE ROOM FOR INCREASED INVESTMENT AND TO LIMIT PUBLIC ABSORPTION OF LABOR RESOURCES DURING RECOVERY. U.K. PLANS TO MEET THIS GOAL BY HOLDING REAL GOVERNMENT SPENDING IN FISCAL YEARS 1977-8 AND 1978-9 CONSTANT AT 1976-7 LEVEL (ALTHOUGH 1976-7 BASE NOT YET DETERMINED, SEE PARA 9), AND WILL SOON IMPLEMENT CASH SPENDING LIMITS FOR CENTRAL AND LOCAL GOVERNMENT EXPENDITURE TO ENHANCE BUDGETARY CONTROL.

14. POINTS RAISED REF B CONCERNING WAGES, BUDGET, NEW
INDUSTRIAL STRATEGY, GROWTH OF MONEY SUPPLY AND EXTENT
TO WHICH STERLING DEPRECIATION HAS OFFSET INFLATION
ARE COVERED IN PARAS 4, 9, 11, 10 AND 6. RE SAVINGS
RATIO, U.K. (LIKE SECRETARIAT) EXPECTS RATIO TO DROP BY
ABOUT 1 PERCENT IN 1976.
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